FISCAL NOTE

Bill #: SB0466 **Title:** Sales tax to reduce income and property taxes

Primary Sponsor: Bohlinger, J **Status:** As Introduced

Sponsor signature Date Chuck Swysgood, Budget Director Date

Fiscal Summary

	FY 2004 Difference	FY 2005 Difference
Expenditures:		
General Fund	($86,097,378)	($336,223,310)
State Special Revenue	$226,873,669	$457,017,335
Revenue:		
General Fund	($100,312,710)	($384,029,252)
State Special Revenue - Sales Tax Account	$227,219,000	$468,992,000
State Special Revenue - University System	($345,953)	($11,974,645)
Net Impact on General Fund Balance:	($14,215,332)	($47,805,942)

☒ Significant Local Gov. Impact ☒ Technical Concerns

☐ Included in the Executive Budget ☒ Significant Long-Term Impacts

☒ Dedicated Revenue Form Attached ☐ Needs to be included in HB 2

Fiscal Analysis

ASSUMPTIONS:

Department of Revenue

Sales Tax

1. Beginning January 1, 2004, this bill would impose a 4% sales and use tax on retail sales of tangible personal property and services with the following exemptions: sales for resale or lease; health services; educational services; agricultural, forestry, fishing and hunting services; radio and television broadcasting; scheduled passenger transportation; farm product warehousing and storage; security brokerage fees; insurance commissions; services a corporation provides to an affiliate or subsidiary that is centrally assessed; telecommunications services subject to the retail telecommunications excise tax; gambling; sales by or to a government or tribe; utilities; unprepared food; prepared food that is part of a residential or health care arrangement; medicine, durable medical equipment, mobility enhancing equipment and therapeutic and prosthetic devices; motor fuels; sales by thrift stores and estates; most agricultural inputs except machinery; agricultural products; minerals or chemicals used in processing ores; components used in manufacturing; and oilfield and mining equipment that must be abandoned in place.
2. During the six months of FY 2004 when the sales tax would be in effect, taxable sales would be $6,211.247 million, and tax liability would be $248.450 million. In FY 2005, taxable sales would be

$12,807.592 million, and tax liability would be $512.304 million. Vendors would collect taxes equal to 95% of tax liability. This would be $236.027 million in FY 2004 and $486.688 million in FY 2005.

3. There would be 55,000 businesses collecting the tax on their sales. Vendors with average tax liability of $100 per month or less would be allowed to file returns quarterly. Ten percent of vendors would file quarterly, and they would make 1% of taxable sales. Quarterly filers would retain 5% of their tax collections as a vendor allowance (see technical note 5). Total vendor allowances retained by this group of vendors would be 0.05% of taxes collected by vendors. Monthly filers would be allowed to retain 1.5% of collections as a vendor allowance with a maximum of $250 per month. There would be 5005 vendors, accounting for 65.6% of taxable sales, who would retain vendor allowances of $250 per month. This group would retain vendor allowances of $15.015 million per year. The remaining quarterly filers, accounting for 33.4% of sales, would retain vendor allowances of 1.5% of collections. This group would retain vendor allowances of 0.501% of taxes collected by vendors. Total vendor allowances would be $15.015 million per year plus 0.551% of taxes collected by vendors.
4. Taxes collected by vendors, less vendor allowances, would be paid to the state. Sales and use tax collections would be $227.219 million in FY 2004 and $468.992 million in FY 2005.
5. All revenue from the sales and use tax would be deposited in a state special revenue fund to be used to support schools and reimburse local governments for lost revenue under 15-1-111. If any funds not required to fund schools would be deposited in the general fund.

<u>Property Tax</u>

6. The proposal impacts property tax revenue by eliminating several statewide mill levies. Gone are the 33, 22, and 40 mill levies (total of 95 mills) for the state general fund, and the 6 mill levy for the university system. The mill levies are eliminated July 1, 2004. The 1.5 mill levy (vo-tech), currently levied in Silver Bow, Cascade, Yellowstone, Missoula, and Lewis and Clark counties, is not affected by the proposal.
7. Elimination of the mill levies will result in a reduction of property tax revenue resulting directly from application of the mill levies and a reduction in non-levy revenue. Non-levy revenues are those revenues that are distributed to governments based on the proportion the government's mill levy is to the total mills of all governments levying mills. The largest non-levy revenue sources are the oil and gas production tax and federal forest reserve payments. Revenue from non-levy revenue sources will be distributed to those governments that continue to levy mills (counties, cities, and local schools).
8. The proposal will result in the elimination of all property taxes received directly by application of the 95 mills levied for the state general fund and the 6 mills levied for the university system beginning with FY 2005. This amount in FY 2005 is estimated to be $167,900,746 for the state general fund and $11,178,188 for the university system.
9. The proposal does not change the non-levy distribution of coal gross proceeds (15-230-703, MCA) and the non-levy distribution of 5% of oil and natural gas production taxes received from pre-1999 wells (15-36-324(12)(b), MCA). The state general fund and university system will continue to receive non-levy revenue from these sources.
10. Prior to elimination of the statewide mills on July 1, 2004, the statewide mill levies are removed from the non-levy revenue distribution of oil and gas production tax (excluding the 5% received from pre-1999 wells) on January 1, 2004. As a result, the state general fund and university system will collect non-levy revenue from this source for the first half of FY 2004. Current law estimates from this revenue source for all of FY 2004 are $11,963,313 for the state general fund and $691,906 for the university system. Current law estimates from this revenue source for FY 2005 are $11,863,406 for the state general fund and $652,773 for the university system. The proposal will result in a reduction in revenue from this source of $5,981,657 ($11,963,313 ÷ 2) in FY 2004 and $11,863,406 in FY 2005 for the state general fund, and $345,953 ($691,906 ÷ 2) in FY 2004 and $652,773 in FY 2005 for the university system. This revenue will be redistributed to local governments and school districts.

11. For purposes of this fiscal note it is assumed that the statewide mill levies are removed from the non-levy revenue distribution of federal forest reserve payments on January 1, 2004 (see technical note # 7). Federal forest reserve payments are made once a year to counties for non-levy distribution usually in January or February. As a result, the state general fund will not collect any non-levy revenue from federal forest reserve payments in FY 2004 and after (the university system does not share in the distribution of federal forest reserve payments). The proposal will result in a reduction in revenue from this source of $2,482,053 in FY 2004 and $2,505,142 in FY 2005 for the state general fund. This revenue will be redistributed to countywide transportation and retirement funds. The property tax impacts are listed in the table below.

SB466
Summary of Property Tax Changes
Estimated Reduction in Property Tax Revenue

State General Fund	FY2004	FY2005
Milled Revenue	0	167,900,746
Oil and Gas Non-Levy	5,981,657	11,863,406
Forest Reserve Non-Levy	2,482,053	2,505,142
All Other Non-Levy	0	2,559,958
Total State General Fund	**8,463,710**	**184,829,252**

University State Special	FY2004	FY2005
Milled Revenue	0	11,178,188
Oil and Gas Non-Levy	345,953	652,773
All Other Non-Levy	0	143,684
Total University	**345,953**	**11,974,645**

Income Tax

12. Beginning with tax year 2004, this bill changes the individual income tax rate table. The current law, ten-tier table with tax rates ranging from 2% to 11% is changed to a three-tier table with tax rates of 3%, 5%, and 7%. As with current law, the bracket boundaries of the proposed law rate table would be indexed

SB466 - TY2004

Individual Income Tax
Current Law Tax Rate Table

0	2,300	2%	
2,300	4,600	3%	(23)
4,600	9,200	4%	(69)
9,200	13,800	5%	(161)
13,800	18,400	6%	(299)
18,400	23,000	7%	(483)
23,000	32,300	8%	(713)
32,300	46,100	9%	(1,036)
46,100	80,700	10%	(1,497)
80,700		11%	(2,304)

Individual Income Tax
Proposed Law Tax Rate Table

0	14,000	3%	
14,000	50,000	5%	-280
50,000		7%	-1280

annually for inflation. The chart shows the forecast current law tax rate table for tax year 2004 and the tax rate table proposed in this bill:

13. Replacing the current law rate table with the rate table in this bill reduces full-year resident tax year 2004 income tax liabilities by $154.110 million in tax year 2004; and by $160.463 million in tax year 2005. Tax liabilities for all filers are reduced by $172.389 million in tax year 2004; and by $182.047 million in tax year 2005.
14. The Department of Revenue will adjust withholding tables beginning January 1, 2004 to accommodate the reduction in tax liabilities stemming from this bill. Taxpayers making quarterly estimated tax payments will adjust their payments in April and June of 2004 in accordance with the tax rate reductions in this bill.
15. The changes to the tax rate table in this bill reduce general fund revenues by $91.849 million in FY 2004 and by $181.440 million in FY 2005.
16. The bill further provides that single individual income taxpayers with incomes of less than $14,000, and married couples and heads of households with adjusted gross income of less than $28,000, would be allowed a tax credit equal to their tax liability beginning with tax year 2004. The tax credit associated with tax year 2004 liabilities is $17.760 million. This credit would be claimed when tax year 2004 tax returns are filed in the spring of 2005, reducing general fund revenues by $17.760 million in FY 2005.

<u>Sales Tax Administration</u>

17. The Department of Revenue would need to implement a new data processing system to administer the sales and use tax. The department would buy software from an outside vendor, and the department and the vendor would customize it. Cost for the system would be $6,260,926 in FY04 and $224,561 in FY05. Computers and office equipment for contract programmers would cost $42,837 in FY 2004. Beginning in FY06, ongoing costs for software maintenance and storage on the state's network would be $220,000.
18. In FY04, the Department of Revenue would need to register 55,000 taxpayers, develop and mail tax forms and instructions, conduct taxpayer education and outreach, and hire and train new staff to administer the sales tax. Beginning in calendar year 2004, the department would process approximately 620,000 returns and audit 1,100 taxpayers each year. The department would hire 61.88 FTE in FY 2004 for processing, compliance, and support work. In FY 2005, the department would hire an additional 27.37 FTE for compliance work. Personnel costs would be $1,928,779 in FY 2004 and $3,306,721 in FY 2005. Costs for computers and office equipment for the additional staff would be $440,407 in FY 2004 and $240,970 in FY 2005. Operating costs, including forms development, travel by auditors, and consulting services from an experienced sales tax administrator from another state would be $582,093 in FY 2004 and $520,598 in FY05. Ongoing costs would be the same as in FY05 except for the equipment costs.
19. Payment to local government units for MCA 15-1-112 is estimated to be $7.02 million in fiscal year 2004 and $5.62 million in fiscal year 2005.

Office of Public Instruction

20. SB 466 allocates a portion of the revenue from the sales and use tax to fully fund the BASE budgets of K-12 school districts. The bill eliminates the BASE levy property tax requirements of school districts.
21. SB 466 eliminates the allocation of HB124 block grants to the school district general fund estimated at $42.68 million in FY04 and $43.00 million in FY05.
22. The distribution of oil and natural gas production taxes is based on the preceding fiscal year. The county equalization funds will receive an allocation of oil and gas production tax revenues in FY04, but not FY05.
23. A school district will use its general fund balance reappropriated and any general fund non-levy revenues to reduce the property tax requirement for the over-BASE portion of the district general fund.
24. In FY 2002, counties remitted $108.0 million to the state treasurer from the county equalization funds. The county equalization funds continue to exist under SB 466, but the bill eliminates the requirement that

the county treasurer remit the monies in the fund to the state treasurer. The state will cease to collect any of the revenues deposited in the county equalization fund.

25. Under SB466, the only revenues that continue to be deposited in county equalization funds are Taylor Grazing, federal flood control, and coal gross proceeds. These totaled $1,835,186 in FY02.
26. The basic and per-ANB entitlements are:

	FY 2003	FY 2004	FY 2005
Basic entitlement EL	$19,244	$19,244	$19,244
Basic entitlement HS	$213,819	$213,819	$213,819
Per-ANB entitlement EL	$3,906	$3,906	$3,906
Per-ANB entitlement HS	$5,205	$5,205	$5,205
Direct State Aid Percentage	44.7%	44.7%	44.7%

27. The statewide taxable valuation will increase by 4.0% in FY 2004 and by 5.5% in FY 2005.
28. Under current law, direct state aid will be $319.27 million in FY 2004 and $314.03 million in FY 2005. Special education payments will be $34.91 million in FY 2004 and FY 2005. Guaranteed tax base aid to schools will be $97.83 million in FY 2004 and $94.93 million in FY 2005.
29. SB466 does not affect the state special education appropriation.
30. Under current law, payments of direct state aid for unusual enrollment increases are anticipated to be $100,000 per year.
31. Under SB466, direct state aid will be $584.74 million in FY 2004 and $575.35 million in FY 2005.
32. County retirement funds will receive an additional $1,502,000 in each year of the 2005 biennium from Federal Forest Reserves. This increase in non-levy revenue will lower the state GTB cost for retirement by $375,500 in FY 2004 and FY 2005.
33. County retirement funds receive an additional $1,232,000 in FY 2005 from oil and gas production taxes. This increase in non-levy revenue will lower the state GTB cost for retirement by $305,000 in FY 2005.

Montana University System

34. SB466 eliminates the six-mill levy for the Montana University System. The bill does not speak to replacement of these funds. It is assumed that this is not replaced with general fund.

FISCAL IMPACT:	FY 2004 Difference	FY 2005 Difference
FTE	61.88	89.25
Expenditures:		
Personal Services	$1,928,779	$3,306,721
Operating Expenses	6,843,019	745,159
Equipment	440,407	240,970
Montana University System	(345,953)	(11,974,645)
Local Assistance - OPI	124,889,516	122,859,920
Local Assistance – DOR (MCA 15-1-112)	7,019,901	5,615,920
TOTAL	$140,775,669	$120,794,045
Funding of Expenditures:		
General Fund (01)		
DOR - Sales Tax Administration	$9,212,205	$4,292,850
OPI	(95,309,583)	(340,516,160)
Subtotal General fund	($86,097,378)	($336,223,310)
State Special Revenue (02)		
Sales Tax Account to OPI	220,199,099	463,376,080

Property tax reimbursement DOR – 15-1-112	7,019,901	5,615,920
University Six mill account	(345,953)	(11,974,645)
Subtotal State special	$226,876,669	$457,017,335
TOTAL	$140,775,669	$120,794,045
Revenues:		
General Fund (01) tax reductions	($100,312,710)	($384,029,252)
State Special Revenue (02)		
Sales Tax Account	$227,219,000	$468,992,000
University System	(345,953)	(11,974,645)
TOTAL	$126,560,337	$72,988,103
Net Impact to Fund Balance (Revenue minus Funding of Expenditures):		
General Fund (01)	($14,215,332)	($47,805,942)
State Special Revenue (02)		
Sales Tax Account	$0	$0
University System	$0	$0

EFFECT ON COUNTY OR OTHER LOCAL REVENUES OR EXPENDITURES:

Department of Revenue

1. Eliminating the statewide mill levies from the distribution of non-levy revenue sources results in the revenue now being distributed to local governments and local schools only. This results in an increase of non-levy revenue for local governments and local schools of $6,327,610 in FY 2004 and $15,021,321 in FY 2005 and after. The countywide transportation and retirement funds realize an increase in non-levy revenue of $2,482,053 in FY 2004 and $2,559,958 in FY 2005 and after. This increase in non-levy revenue will not necessarily result in lower mill levies. Under the mill levy cap in 15-10-420, MCA, local governments are not required to reduce mill levies if non-levy revenues increase.

Office of Public Instruction

2. SB 466 requires the state to fund the entire BASE budget. Currently the state funds 44.7% of the entitlements. The remaining portion of the BASE budget (35.3% of entitlements) is funded with a mix of state general fund and local non-levy and levy revenue. Under SB 466 districts will not need to levy mills in the BASE area of the budget and will be able to use non-levy revenue above BASE. This will reduce BASE levies by $124,889,516 in FY 2004 and $122,859,920 in FY 2005. On average this results in approximately a 71-mill reduction statewide.
3. The funding of the BASE budget with sales and use tax monies will make non-levy revenues and fund balance reappropriated available to fund the over-BASE portion of the general fund budget. District over-BASE property taxes are projected to decline by $25 million in each year of the 2005 biennium. On average this is equivalent to approximately a 14-mill reduction statewide. Districts may choose to continue above BASE levies.
4. Property tax levies for county retirement are projected to decrease by $1.13 million in FY 2004 and by $1.43 million in FY 2005.

LONG-RANGE IMPACTS:

1. Sales tax collections are expected to grow by about 3.1% per year on average. Ongoing costs of sales tax administration would be approximately $3.352 million.

2. Total estimated reductions in property tax revenues for FY 2005 are $184,829,252 for the state general fund and $11,974,645 for the university system. The estimated reductions for FY2006 and beyond would equal the FY 2005 values plus some growth.
3. The changes to the individual income tax rate table reduce FY year 2006 tax liabilities by $190.311 million. The low-income tax credit reduces individual income tax liabilities for fiscal year 2006 by an additional $18.183 million. General fund revenues from the individual income tax are reduced a total of $208.494 in FY year 2006 under this bill. This reduction is expected to grow over time.

TECHNICAL NOTES:

1. DOR - Section 11 exempts certain types of services from the sales and use tax. It defines those services with reference to the North American Industry Classification System (NAICS). The NAICS manual contains definitions of industries, not of goods and services. For example, subsection (a) exempts health services and cites NAICS sector 62. NAICS sector 62 consists of establishments whose primary function is providing health care and social assistance, but these establishments also sell a variety of other goods and services. For example, many hospitals have cafeterias or snack bars and gift shops. This fiscal note assumes that the exemptions in section 11 are for sales in the primary lines of business that define the NAICS industries referenced, not for all sales by establishments in those industries. The NAICS industry classification system was developed by the Census Bureau and its counterparts in Canada and Mexico. The agencies are in the process of developing the North American Product Classification System (NAPCS), which will be a classification system for goods and services. Preliminary NACPS definitions are available for some types of goods and services. Section 11 should reference NACPS definitions where they are available. Otherwise, the bill should provide definitions or leave definitions to the rulemaking process.
2. This bill taxes sales of tangible personal property. It exempts leases of mobile homes but does not specifically exempt sales of mobile homes. Mobile homes are personal property if they are not permanently attached to a foundation (See MCA 15-1-101(i)). This fiscal note assumes that sales of mobile homes would not be subject to the tax, but without an explicit exemption, a small percentage of sales of mobile homes probably would be taxable.
3. Subsection 11(e) makes several types of transportation services subject to the sales and use tax. States can not tax interstate commerce, so that only a portion of these services can be taxed. In particular, most truck transportation and most, if not all, pipeline transportation, is interstate.
4. This bill does not explicitly tax or exempt rental or lease of tangible personal property. However, since it exempts sale or lease of tangible personal property for subsequent lease and lease of real property and mobile homes, this fiscal note assumes that rental or lease of tangible personal property is a sale of a service and therefore taxable.
5. Subsection 40(3)(b) allows vendors with average monthly tax liability of less than $100 to file quarterly tax returns. This threshold is equivalent to annual taxable sales of $30,000 ($100 = 4% x $30,000 / 12). Subsection 42(3)(b) allows quarterly filers to retain a vendor allowance of 5% of the tax with a maximum of $150 per quarter. This maximum is 5% of the tax on $75,000 of taxable sales ($150 = 5% x 4% x $75,000). Since quarterly filers must have annual sales of $30,000 or less, the vendor allowance would be 5% for all quarterly filers.
6. Section 64 amends MCA 15-1-112(13)(a) to remove the four years of the reimbursement phase-out that have already occurred. For consistency, page 39, line23 should be changed to read “5 years” instead of “9 years.”
7. Section 76 is to amend MCA 17-3-213, but there are no changes in the text. For the purposes of this fiscal note it is assumed that the intention was to delete 17-3-213(5)(b)(i) and 17-3-213(5)(b)(ii), in effect

removing the 33 mill levy and 22 mill levy from the distribution of federal forest reserve payments. The effective date for Section 76 is January 1, 2004.

8. It is assumed that the tax rate table in Section 73 of the bill is the rate table that will be in effect beginning with tax year 2004. The bracket boundaries of this rate table will be adjusted for inflation every year after 2004. If this is true, then subsection 10 of Section 72 of the bill should be amended to provide that "Inflation factor" means a number determined for each tax year by dividing the consumer price index for June of the tax year by the consumer price index for *June 2004*, rather than June 2003.
9. The information technology (IT) project required to implement this legislation would require the review and approval of the Chief Information Officer (CIO) as provided for in 2-17-512, MCA.
10. Implementation of this tax will require the Department of Revenue to implement a computer system to automate the administrative requirements of registration, return processing, customer and revenue accounting, and compliance activities. The expenditure will involve millions as shown by this estimate. Projects of this size are normally pursued through a Request For Proposal procedure outlined by the Department of Administration and can routinely take up to 6 months of careful planning and review before selecting a vendor or product that meets the department's requirements. The proposed effective and applicability dates in SB 466 do not allow for the time required to proceed with the normal procurement processes defined in statute. Unless implementation of this act could be identified as an exception to those requirements, the effective date of the act may have to be amended to July 1, 2004 and applicable to sales occurring after June 30, 2004. Compressing timelines allotted to preproject due diligence and vendor selection increases project risk.
11. The reference on page 34 Section 62 line 18 15-1-111 should be 15-1-112.

Office of Public Instruction

12. While the county equalization funds continue to exist, there will not be enough revenue in these funds to pay for mandatory out-of-district tuition payments. An appropriation will be needed to fund out-of-district tuition in counties that do not have enough revenue in the county equalization account to cover tuition costs.
13. The Office of Public Instruction makes BASE aid payments directly to school districts through electronic funds transfer. The payment to schools is not made from the county equalization accounts. It appears to be an error to have deleted from statute (Section 84, subsection 13 of SB 466) the requirement that county treasurers remit the revenues in the county equalization accounts to the state treasurer.
14. Federal impact aid is allocated to school districts based on the number of federally-connected students. A factor in the federal payment calculation is the local contribution rate of the school district. In Montana, the 55-mill levy is included in the calculation of a district's local contribution rate. If that 55-mills were eliminated, school districts would experience a significant reduction in receipts of federal impact aid.

Montana University System

15. SB 466 eliminates a significant portion of University System funding with the elimination of the six-mill levy. General fund may be used to offset this reduction, but this fiscal note does not show this replacement of funds.

DEDICATION OF REVENUE:

a) Are there persons or entities that benefit from this dedicated revenue that do not pay? (please explain)
None known.

b) What special information or other advantages exist as a result of using a state special revenue fund that could not be obtained if the revenue were allocated to the general fund?
None known.

c) Is the source of revenue relevant to current use of the funds and adequate to fund the program activity that is intended? No (if no, explain)
The revenue from this tax probably is not enough to fund the targeted expenditures.

d) Does the need for this state special revenue provision still exist?
Under current law, these expenditures are appropriated from the general fund.

e) Does the dedicated revenue affect the legislature's ability to scrutinize budgets, control expenditures, or establish priorities for state spending? (Please Explain)
A significant portion of the total state budget would be non-general fund. The Legislature would need to look beyond the general fund in order to fully understand the state budget.

f) Does the dedicated revenue fulfill a continuing, legislatively recognized need? (Please Explain)
The constitution mandates state funding of K-12 education, but under current law, these expenditures are appropriated from the general fund.

g) How does the dedicated revenue provision result in accounting/auditing efficiencies or inefficiencies in your agency? (Please Explain. Also, if the program/activity were general funded, could you adequately account for the program/activity?)
The Department of Revenue and the Office of Public Instruction would not be materially affected by whether sales tax collections are deposited in the general fund or a special revenue fund.